

## How will Europe work?

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In theory, enlargement to 25 countries will give the European Union the critical mass necessary to challenge US economic supremacy. In practice, the EU has found decision-making increasingly difficult with just 15 members. Karina Robinson on the big gamble

The European Union is set to become the world's largest economic area when in 18 months it becomes a grouping of 25 nations rather than 15. The real questions are how it can work and whether it can beat the US in terms of competitiveness and job creation. Big is not necessarily better. Overcoming structural impediments and undertaking reform without losing its particular characteristics - what might be termed a softer model of capitalism than the US version - will be even more difficult with the addition of countries that do not share a common mind set.

Ironically, the dissimilar culture of the candidate countries from behind the former Iron Curtain may lead the current western European members to realise their similarities, rather than harping on about their differences, a recognition that may result in less squabbling among the existing states.

"Up to now, the 15 members of the EU have been very homogeneous, but it won't be the same for 25 following the wave of enlargement in 2004. What happens up to now for the 12 countries that have the euro and the three that don't is not that different except in monetary policy. But in future the economic policies for the 12 versus the 25 will be very different," Pedro Solbes, European Commissioner for Economic and Monetary Affairs, told *The Banker* (for full interview see page 24).

This does not only apply on the economic front. Take democracy: long-standing in Western Europe, less than 13 years old in the East. Or immigration: the candidate countries are net exporters, the existing members are net importers.

"I think it is almost an ethical obligation to bring in countries that have accepted the model we have suggested of democracy and a liberal economy," says Mr Solbes.

However valid his point, the reality is that the existing member states have already been arguing over matters including the Common Agricultural Policy (CAP), how to represent member states, whether to accept majority voting in more areas and how an EU defence policy should work. As a result, says Harald Benink, a member of the European Shadow Financial Regulatory Committee, a think-tank, there will be quite a few crises before acceptance of the 10 is a fait accompli: "Enlargement is only making the existing game more complicated. We have been postponing the decision-making process on many of these issues but it cannot continue."

### Accession fever

At the Copenhagen summit in December, the EU clinched negotiations with the 10 candidate countries, which are then set to run referenda on whether their citizens want to join. Romania and Bulgaria were given their proposed accession date in 2007, assuming they continue their reforms.

As for the controversial issue of Turkey's joining the club, the EU agreed to start entry negotiations after December 2004, despite former French President Valerie Giscard D'Estaing, the head of the European Convention, saying this would mean "the end of Europe." But Ankara will have to improve its volatile economy, reinforce democracy and deal with its human rights record.

Enlargement does give an added urgency to solving the issues the EU is having trouble dealing with before they become even thornier. The European Convention (see box, page 17) is helping in that process by devising a constitution that will build on and supersede the four basic treaties that are the building blocks of the EU. Legal documents are – however awkward – unavoidably the basis of the EU because it is made up of nation states.

A June 2002 Commission proposal on the future of Europe calls for the Convention to confirm that "an à la carte Europe is not the right option for the future development of the Union". It argues the many exemptions on different matters, built up over years of horse-trading between the countries involved, are obstacles enough in the smooth running of the Union. With enlargement, they will become virtually insurmountable.

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## Harmonisation hassles

This underlines one of the main debates in Europe: to what extent harmonisation is necessary and how much of a transfer of power to the EU this involves.

EU bodies realise the charge laid at their door, namely unnecessary power grabbing rather than "subsidiarity" (EU-speak for allowing decisions to be taken at the most local level). The Commission's proposal for the Convention suggested some measures – such as increased majority voting – which are controversial and critics argue fall under this heading. But in the same document, the Commission underlined European citizens' desire for "greater clarity, more democratic control, and a Union which respects national identities... a new form of organisation far removed from the 'super-state' myth", and noted that more had to be done to ensure subsidiarity and proportionality were adhered to.

It noted that European directives sometimes generate "national rules which are excessive" and lead to "people accusing Europe of excesses for which it is not responsible." It wants the Convention to look at implementing specific control procedures to ensure European rules which could be done more efficiently at a national or local level would never make it into national law, and to examine prevention of excessive national regulations by national administrations based on their interpretation of EU law.

## Challenging the US

All very well. But the basic dilemma remains: will it take more harmonisation or less to compete with the US? The EU has been lagging behind the US in terms of economic growth, job creation and productivity since its inception. In the last decade from 1991 to 2000, US GDP averaged 3.3% a year with strong productivity growth, while the EU averaged only 2.1% and its productivity decreased (see graph).

"One of the big flaws in the EU is labour market productivity. Normally, when you have economic growth labour productivity increases. But in the EU in the second half of the 1990s it decreased further, and the latest statistics show it continuing to go down which is most preoccupying," says Karel Lannoo, chief executive officer of the Brussels-based Center for Policy Studies. "The EU does not seem to be adapting to what's happening in the global economy."

A number of national policy-makers blame the raft of EU social legislation. But Mr Lannoo says this is simply shifting the blame: "Maternity leave [and the like] is not fundamental. What is fundamental is the cost of social security at a national level."

Most EU governments have failed to tackle it properly because of the political cost.

Should the pressure then be applied at an EU level? To a certain extent the Commission is trying to do that with its adjustments to the Stability and Growth Pact which underpins the euro.

Mr Solbes says he wants countries with debt over 100% of gross domestic product to come up with clear-cut proposals to reduce it and emphasises that this is even more pressing for countries overwhelmed by unfunded pension liabilities, including Italy and Belgium. Still, on a slightly less urgent basis, countries like Germany and France also have to tackle their pensions problem. It is, to re-use a cliché, a ticking time-bomb.

It will not be dealt with through growth in the existing population, which is forecast negative on the Continent as a whole, including the candidate countries.

Therefore enlargement will not help with the ageing of the population and what this means for retirement ages, for social security budgets, for the huge black hole that most governments have not faced up to. "The ageing of the population is the same in eastern Europe where they have similar low fertility rates, a legacy of their Communist system. We are a dying continent," says Mr Lannoo.

The only solution is immigration, yet another topic that Europe's politicians approach timidly, especially following the rise of populist parties in countries like Holland and France which have benefited from the confusion in the public mind between a minority of scroungers and the majority of hard-working immigrants in search of a better life, the sort that have helped the US beat Europe in the economic race for decades.

Immigration is also the great fear when it comes to Turkey's possible accession to the EU. European politicians may find they cannot overcome their citizens' fears and the political backlash this might mean for them.

Free movement of labour from the countries that join in 2004 will not apply for at least seven years. Studies show that for Spain and Portugal, which faced the same delay in labour mobility when they joined in 1986, economic advances as a result of EU membership lead to less of their citizens living in other countries in the EU by 1995 than

before. The idea of a wave of immigration from the east is misguided; in any case, with growth in Europe forecast at only 2% next year, and German unemployment remaining in double figures, employment opportunities will be in the new members.

The immigrant workforce will have to come from outside the enlarged EU, where high birth rates, conflict and the lack of local opportunities will ensure a steady supply. This will change the character of the Union, whether or not a country like Turkey is given a firm accession date or Russia decides to apply.

Allied to the challenge of finding a workforce, is the high cost of government in the EU. Despite two decades of privatisation and the realisation that the welfare state is unsustainable, 47% of GDP in the EU still comes from government spending. The CAP is a sizeable part of that and an agreement stitched up between the French and the German leaders a couple of months ago failed to deal with the issues.

## Over-regulation and taxation

The EU's particular, softer style of capitalism compared with the US, is dependent on higher growth rates. When the problems of the over-regulated and over-taxed German economy are stalling growth in the former engine of Europe it is obvious some serious decisions are needed.

Enlargement may allow the EU to put off some of those decisions. The cost of becoming a grouping of 25 is estimated at 1.27% of EU GDP, not a large amount considering the opportunities it opens up.

"The old EU will benefit from the unique chance of access to fast-growing, emerging Europe, the [economic scenario] we had in the 1950s and 1960s," says Herbert Stepic, deputy chairman of the board of management of Austrian bank RZB and the driving force behind its expansion into the candidate countries.

"In Europe and worldwide we are coming out of a time of extreme prosperity, into a time where we have to tighten our belts. The growth rates that allowed us to go for welfare spending [are no longer around] so how lucky we are in western Europe to have eastern Europe nearby," he adds.

But deregulating and freeing up labour markets in the EU is still crucial.

Charles Kupchan, a senior fellow at the Council on Foreign Relations, a US think-tank, believes it is possible for the EU to match US growth rates.

"Much of the venture capital that was in the US during the 1990s is now in Europe, potentially fuelling increases in productivity. If Europe is able to move forward on further deregulation of its economy, it will further increase the likelihood that the EU may enjoy growth rates comparable to America's," he says. "In any case, the EU is emerging as an alternative center of economic and political power to the US."

## Unfulfilled potential

It may be an alternative centre, but the EU has not fulfilled its potential on the international scene, despite a population of 376m, GDP at market prices of \$8,460bn, a well-honed diplomatic skill base and sizeable aid budgets. Foreign policy collaboration is not helped by having two EU representatives, High Representative Javier Solana and External Relations Commissioner Chris Patten.

In a bid to improve this, the Commission has suggested in its proposals to the Convention that majority decisions rather than unanimity be the rule for foreign policy decisions bar security and defence, and that the representative be only one.

"A single spokesman would enhance the EU's diplomatic weight in the world. In the first instance, this would encourage more competition with the US; Europe would more frequently hold its ground versus Washington. Over the longer run, it might work to the advantage of US-EU relations by making Europe a more effective partner," says Mr Kupchan.

The rocky path The EU needs to become more effective in many more ways. It is in the midst of an historic process. Following the Copenhagen summit the EU train is set on a route that is unalterable. But it will be a bumpy ride. The addition of another 10 countries makes it even more urgent to deal with streamlining the decision-making process, publishing a constitution, speeding up the creation of a veritable single market and removing structural rigidities.

This year is crucial as decisions need to be made before the EU becomes too large to handle. Whether it is up to the challenge – whether it can increase its growth rates, provide employment opportunities and modify but not lose its version of capitalism – remains to be seen.

What should not be forgotten is that bringing in the candidate countries has a historic dimension. The EU has helped prevent war in the Union for over 50 years. If it can do as much for the new members, that is already a worthwhile contribution.

"The accession of eastern Europe is the fulfilment of a safe and secure Europe," says Mr Stepic.

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